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BUSINESS AND THE FIRST AMENDMENT

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Business And The First Amendment

I am very pleased to have an opportunity to address this distinguished group today.

"Freedom of speech -- open government -- the right to privacy. All of these are important principles in a democracy. But they sometimes come into conflict and the businessman is often caught in the middle." These words, which ring so true, are taken from the cover of the brochure announcing this seminar on Business and the First Admendment. They also capture the very essence of the ideas I had determined would be the subject of my remarks from the very day I was invited by John Olson to be your luncheon speaker.

I should probably start by acknowledging the basic premise that the First Amendment right to freedom of speech is of paramount importance to our society, and should not, as a general rule, be impinged upon by the government. Yet, as society grows in size and complexity, our individual liberties must be circumscribed for the good of the community at large. This fundamental concept holds true for businesses as well, and for their "freedom of expression." On reflection, it is actually surprising the number of ways in which government limits a businessman's ability to communicate with the public as he sells his goods and services. The securities industry (indeed the entire capital raising process) is no less subject to such restrictions than any other industry. For example, the securities laws empower

the Commission to regulate the manner in which a broker-dealer may advertise its services; to regulate the contents of an issuer's prospectus -- that peculiar hybrid that is both disclosure document and sales brochure, and before SEC v. Lowe I thought it reasonably clear that the Commission had considerable power to regulate investment advisors' recommendations to their clients whether verbal or written. Unfortunately, the Supreme Court has cast some doubt on the question without clearly defining the scope of our authority in that area.

I am not going to spend the next twenty minutes presenting a diatribe on Lowe and the impact of the First Amendment on investment newsletters. Oh no! I gave that speech last year and fell miserably short of the mark in guessing what the Supreme Court would do. Rather, today my focus will be on an issuer's obligation to its shareholders and to the market-at-large not to mislead when making public pronouncements. If I am to believe securities law commentators, financial reporters and SEC watchers in general, the fairly straightforward concept that a company may not make misleading public statements, becomes very complex in the context of disclosure of possible corporate change of control transactions. For those of you who do not fit into any of the categories I mentioned, let me explain. The Commission recently had the temerity to suggest that when an issuer makes a public statement about an important corporate event, it is obliged to ensure that the statement is truthful and, if it is not, to correct it -- even if the corporate event was a potential merger.

The Commission took this position in a report issued at the conclusion of an investigation conducted by the Commission in the matter of Carnation Company. 1/

Frankly, I was surprised by the hue and cry that followed the Commission's 21(a) report in the Carnation matter. Once again the Commission was being accused of being overly aggressive in its regulation of speech and of expanding the current reach of the law. I thought that a seminar on Business and the First Amendment presented the perfect opportunity to address some of the questions on the responsibilities and liabilities of public corporations raised as a result of the Carnation report.

With respect to the Carnation matter, the Commission has not gone off on a frolic of its own in issuing that report, nor are we flouting the word of the courts. Quite to the contrary. During the course of my remarks, I hope to demonstrate that the Commission's decision in Carnation fits clearly into the framework of legal precedent and how, nothwithstanding the First Amendment, some restrictions are indeed necessary and warranted in this area. Finally, I will respond to some of the concerns raised by critics of the Carnation report and hopefully will be able to assuage some of the fears to which the report has apparently given birth.

1/ In Re Carnation Co., [1984-§1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶83,801 (July 8, 1985).

Perhaps I should very briefly give you some background facts on the Carnation matter on the off chance there are a few of you that do not read every word printed about what the SEC has done to the world lately. During the pendency of merger negotiations between Carnation and Nestle, rumors concerning a possible takeover of Carnation by Nestle hit the marketplace resulting in an increase of Carnation's stock price. The ensuing press inquiries to Carnation were responded to by a company spokesman who indicated that "there is no news from the company and no corporate developments that would account for the stock action". While the spokesman's remarks were not intentionally false because he personally had no knowledge of the negotiations, the statements were nonetheless misleading since Carnation was in fact involved at that time in merger discussions. Incidentally, the spokeman in question was the Treasurer of the company and one of several officers designated by management to handle inquiries from the press. A few weeks later, in response to further questions from the press about the persistent rumors that Carnation was "in play", the same spokesman was reported to have stated that to his knowledge, there was "nothing to substantiate [the rumors]" and that "we are not negotiating with anyone." The resulting news articles caused some concern for Carnation's investment banking firm. It really did not require a genius to figure out that under the circumstances, the company's unqualified denials created some exposure under the securities laws because

the statements were possibily false and misleading. The investment bankers persuaded Carnation's chief executive officer to instruct the company spokesmen to respond to future questions with a simple "no comment".

In considering the Carnation matter, the Commission struggled long and hard with the question of what must be disclosed when an issuer speaks to the public, particularly when delicate merger negotiations are hanging in the balance. The Commission is sensitive to the constraints within which businessmen must operate sometimes. Nevertheless, it concluded that issuers, if they choose to speak, must make accurate public statements about their condition, status and activities. Thus, the Commission decided that enforcement action was warranted against Carnation.

Now, I must admit I really don't understand why so many Commission watchers seem to have lost sleep over the Carnation decision. It is clear to me that the legal underpinnings for the report are sound and that the Commission's decision is totally in keeping with previously articulated policies. Although not the case here, there are a number of circumstances in which disclosure is not only mandated but the manner in which it is made is prescribed. Take the most fundamental example, the registration provisions of the '33 Act. Those provisions detail information that must be disclosed in connection with stock offerings. And, how about the proxy rules which require that all persons whose

votes are solicited must be furnished with written proxy statements containing specified information. Not only do the securities laws regulate the specific content of certain types of communications between businesses and the investing public, it goes further. Rule 12b-20 under the '34 Act provides:

> In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

Finally, you will all concede that Section 10(b) of the 1934 Act proscribes the making of materially false or misleading statements.

Mind you, I am not saying nor, to my knowledge, has the Commission ever said that issuers have a general duty to shout immediately to the world the news of every significant corporate development. No one is suggesting that because you are free to speak, you are obliged to speak. What I am saying, and what the courts have said since Texas Gulf Sulphur 2/, is that when an issuer elects to speak, it must be honest in doing so. False statements and incomplete statements that are misleading can not be tolerated. Furthermore, an issuer may not leave uncorrected a material statement which it subsequently learns is false or has become false.

2/ SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied. 394 U.S. 976 (1969).

Of significance in this context, however, is the fact that the Commission has stated that an issuer is permitted to say "no comment" in response to inquiries from the press without running afoul of the Federal securities laws. However, a "no comment" response would clearly be unacceptable when market rumors are already flying as a result of leaks from the issuer itself concerning a potential merger. It also follows that a "no comment" response would be clearly inappropriate if subsequent events render earlier statements false and misleading. or if, as in the case of Carnation, a false statement is made and stands uncorrected.

Certain commentators have pointed out that the SEC's position in Carnation is contrary to that adopted in a Third Circuit Court opinion upon which many corporate spokesmen (and their legal advisors) apparently rely to justify what may be called less than candid reponses to inquiries by the press about pending corporate transactions. The Commission was neither hesitant or equivocal in expressing it's view that the case in question had been wrongly decided. Well! That sort of self-assertedness had to invite a few jibes. One commentator stated ... "the Commission does not have the power to overrule the courts any more than it can legislate in place of Congress, although at times it seems to assume both powers."

From my viewpoint as a litigator, (or former litigator I should say) a single judicial decision hardly constitutes binding across the board precedent unless of course it is a

decision of the U.S. Supreme Court. Moreover, there is nothing wrong with taking issue, respectfully of course, with a court holding. We litigators, or former litigators turned regulators, do it all the time during the course of helping the courts "find the law." I do not accept the premise that the SEC is obliged not to speak on a subject once a court has spoken. Besides, the First Amendment gives us the right to do so.

The fact that the Federal securities laws regularly regulate an issuer's ability to communicate with the investing public, makes me wonder why an official pronouncement that one must speak truthfully when one speaks should create such consternation. I have heard that investment bankers and their lawyers have suggested that the position adopted by the Commission in the Carnation 21(a) report is impractical and will have the "effect of chilling merger discussions". In a recent article in the Wall Street Journal, 3/ one investment banker was quoted as saying "deal making is chemistry, and the most important catalyst is confidentiality. The more people who know, the less chance there is of getting it done". I do not disagree but the Commission did not say anything about breaking an accepted code of silence -- no one has said if you are discussing a merger you must tell the world. It is only once you opt to break your silence that you must watch your step.

3/ Daniel Hertzbert and Ed Leefeldt, "SEC's Merger Disclosure Ruling May Add to Stock - Price Volatility," Wall Street Journal, July 10, 1985, p.31 Statement by Porter Bibb of Ladenburg, Thalmann & Co.

Frankly, I cannot accept the arguments offered in support of the proposition that the SEC should not regulate public statements relating to preliminary merger discussions. One commentator suggested that the Commission's position might sabotage worthwhile mergers by causing premature disclosure of merger negotiations. 4/ I rather doubt that is the case, and I reemphasize that the SEC's position does not require disclosure. In any event, the Commission's mandate is to protect investors and ensure the integrity of the capital markets. Consummating "the deal" does not take priority over those goals.

It has also been suggested that truthful disclosure would be detrimental to the small investor. Those espousing this view contend that statements made prematurely will incite the small investor to jump into the market and trade on the basis of very little information. Not only, so the critics say, will the information be scant but in many instances it will be inaccurate since negotiations frequently do not culminate in affirmative action. The kindest comment I can make about such arguments in support of an issuer's presumed right to mislead the public if it determines it is in the public's interest to be misled, is that they are unpersuasive and paternalistic! By all accounts, the average investor, be he large or small, is not in such need of being saved from himself that he should be kept immobilized by misinformation about corporate activities.

4/ Francesca Lunzer, "No Comment", Forbes, November 16, 1985.

One of the principal goals of the securities laws is to ensure investor decisions are well reasoned and based on accurate information rather than on half-truths.

There also seems to be a misperception that the position articulated by the Commission in the Carnation report requires a company spokesman to sit in the lap of the CEO or the board of directors so that they have up to the minute and accurate information to report publicly. Not so! However, a corporation may not use an uninformed spokesman as a shield. Clearly, the public impression is that any public announcements made are of those of the corporation and not those of the individual spokesman. Therefore, a corporation is obliged to ensure that the information delivered must be truthful or alternatively, no information should be passed on at all. How it does that is up to its management.

Happily, the Commission is not without its supporters with regard to its position on public statements disclosing corporate transactions. For example, an arbitraguer at Prudential-Bache Securities in New York reportedly characterized the Commission's move as favorable in light of the "great abuse of the integrity of the marketplace". 5/ This person went on to note that the Commission's report merely replaced discretion with regulation and would not have an impact on legitimate merger

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5/ Al Delugach, "SEC Warns U.S. Firms on Merger Disclosure," Los Angeles Times, July 12, 1985, referring to a statement by Gruy Wyser - Pratte of Prudential-Bache Securities.

proposals. Others have suggested that investors will benefit from more forthright disclosures because there will be more information available upon which to base investment decisions. Here, here!

After all, disclosure is the raison d'etre for the federal securities laws. In fact, the preamble to the Securities Act of 1933 makes clear that the Act's purpose is to "provide full and fair disclosure of the character of securities sold in interstate ... commerce ...., and to prevent frauds in the sale thereof". Supplementing the disclosure obligation is the responsibility of public corporations to disclose in a timely manner both favorable and unfavorable material information and to be certain that those disclosures are accurate, that they are in no way misleading.

You may ask, does the SEC have the authority to regulate the speech of public corporations? Well, I believe that it is clear that the Constitution does not prohibit the government's right to prevent fraud as long as any limitation is narrowly constructed and as long as the government does not overreach. That commercial activity takes the form of speech does not necessarily immunize it from regulation. Remember, there is no First Amendment right to commit fraud. There is, however, an unquestioned national interest in maintaining the fair and orderly operation of the capital markets. There exists a common law relation of trust and confidence between a corporation and its shareholders which gives rise to a duty, once statements are made, of fair and accurate disclosures of material information.

As the Commission admonished in a recent release, the

> ... "[A]nti-fraud provisions of the federal securities laws apply to all company statements that can reasonably be expected to reach investors in the trading markets .... [T]hus, as with any communications to investors, such statements should not be materially misleading, as the result of either misstatement or omission. 6/

There is no doubt that a certain degree of tension will always exist when government moves to regulate what are perceived to be legitimate business activities. When the regulation is applied to speech, the tension tends to become explosive. I suppose that explains the immediate widespread vocal reaction to the Commission's report on Carnation. It seemed that everyone had something to say about it. I believe that the Commission's position is rational, correct and necessary, not to mention well within the traditional parameters of securities law regulation. Here's hoping the U.S. Supreme Court does not prove me wrong again.

Thank you.

6/ Securities Act Rel. No. 33-6504 (January 19, 1984).